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Current Ratio: Revisited

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Abstract

The current ratio is a popular metric that measures a firm's ability to pay off its short-term liabilities with its current assets. Since the ratio is current assets divided by current liabilities, it implies that the company will probably not face a liquidity problem if the current ratio is larger than one. The reverse is implied if the ratio is less than one. This will be true only if the two sides of the ratio (numerator & denominator) are properly matched in terms of the period covered and the frequency of occurrences.
In this paper, I argue that the two sides of the ratio, though properly matched in terms of the period covered, are not matched in terms of the number of times cash is collected, in the numerator, and the number of times cash is paid, in the denominator. This limits the usefulness of the ratio especially when it is less than one. I propose a new definition of the current ratio that will consider the above issue.

Keywords: current assets; current liabilities; operating cycle, payables turnover, receivables turnover.